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Intelligence Memorandum

Repercussions From Sterling Devaluation

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
28 November 1967

INTELLIGENCE MEMORANDUM

Repercussions From Sterling Devaluation

Summary

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The impact of sterling devaluation, which last week set the stage for a frantic run on gold and severe pressure on the US dollar, appears to be moderating considerably. Coordinated efforts by the major financial powers to support the dollar have bolstered confidence within the foreign exchange markets. Although heavy demand for gold by speculators continues, apparently encouraged in part by the French, the volume of London gold sales on Monday, 27 November, and on Tuesday morning declined sharply in comparison with the activity of the previous week. About 20 countries have followed the UK in devaluing their currencies. Some of these countries had their own economic compulsions for devaluing, and none is a major trading nation.

British Prime Minister Wilson succeeded in holding the Labor Party in line during last week's parliamentary debate on devaluation, but his personal credibility declined. British entry into the European Community appears to be supported just as strongly by the Five, who remain at odds with Paris on the timing and requirements of full British membership.

Note: This memorandum was produced solely by CIA. It was prepared jointly by the Office of Economic Research and the Office of Current Intelligence.

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Introduction

1. Britain's devaluation of sterling on 18 November induced at least 20 smaller countries to devalue their currencies and set the stage for a run on the London gold market that by 24 November had reached panic proportions. Although the full repercussions of sterling devaluation have not yet been felt, there is some evidence from world financial centers that for the immediate future the financial crisis has passed.

The Run on Gold

2. The frantic gold buying that reached $580 million on the London market during the week ending 25 November currently shows signs of slowing down. Sales of gold from the London Gold Pool* on Monday, 27 November, were $60 million, representing a sharp decline compared with sales of $260 million the previous Friday.** As of 2:00 p.m. 28 November (London time), gold sales were almost exactly balanced by gold purchases. The price of gold, fixed daily by the London Pool, was set on 28 November at $35.1984 an ounce, slightly below Friday's price. Sales of gold on the Paris bullion market were unusually high during the week ending 24 November, although well below sales in London, and remained high in trading early in the following week.

**The US, UK, West Germany, Italy, Belgium, Netherlands, and Switzerland are active members of the London Gold Pool, which was established in 1961 to stabilize the price of gold. France, an original member, withdrew its support in June 1967.*

***Eastern Europe bought $28 million of gold from London on Friday and Communist China purchased $5 million on Monday.*

3. Gold sales in London had built up during the week ending 25 November from $106 million on Wednesday to the peak of $260 million on Friday, reflecting a rush into gold by speculators who felt that the sterling devaluation might trigger an increase in the dollar price of gold. Another week of scrambling for gold would have placed new pressure on the US dollar. The trend in sales of gold that was set tentatively in the London market on 27 November and early on the 28th, however, implies that pressure on the dollar will likely decline during the rest of the week. In all of Western Europe's foreign exchange markets, US dollar rates on 27 November rose above the lower support levels and remained strong on the 28th.

4. There is little danger that the present run on gold will actually undermine the dollar, in view of the $29 billion in gold held by the seven active members of the Gold Pool. It is possible, however, that the present buying wave will continue to draw down gold reserves before it subsides. The US has indicated through the President's statement on 24 November and through subsequent Treasury statements that it will support the dollar with its entire gold stock (announced by the Federal Reserve System last week as $12.9 billion). Although France has withdrawn from the Gold Pool, the remaining members of the pool are expected to continue active participation. On 25 November Belgium published an official denial of rumors (in the French press) that it would withdraw.

5. The primary reason for renewed strength of the dollar early in the week of 27 November and apparent declines in gold speculation is the strong evidence of solidarity among the major financial powers. The members of the Gold Pool met in Frankfurt, Germany, on 26 November and promptly pledged coordinated support for the US dollar. Moreover, Japan and Sweden, although not members of the Gold Pool, have become heavily involved in dollar support operations.

6. Short-term dollar claims held by foreigners amount to around $15 billion, but much of this is not available for immediate conversion into gold. There are only six countries outside the United States--Germany, Italy, Japan, Canada, Australia, and the UK--

that hold dollar reserves in excess of more than $1 billion each, and these countries almost certainly will refrain from any attack on the dollar. French dollar holdings are about $500 million, but at least half this amount is essential to finance current trade and other international transactions. Although France alone cannot start a sustained run on gold, deliberate French actions can induce heavy gold purchases by speculators and other buyers.

7. On 26 November the British press, including the conservative Sunday Telegraph and the independent Observer, blamed the current "gold rush" on the French. The French are said to be engaged in a propaganda offensive that aims to increase speculation against the US dollar in the London gold market. The ultimate objective is to force an increase in the price of gold, i.e., a devaluation of the dollar. Similar charges have been mentioned in private by Western officials and leading bankers.

8. President de Gaulle, in his news conference on 27 November, reiterated a statement made last year that gold, rather than the pound sterling and the US dollar, should be the sole currency base for international trade. He also expressed his opinion that the present uneasiness in international money markets and other pressures on the US dollar may force the dollar into the same precarious position that sterling faced before devaluation. His news conference remarks, however, are not expected to have much impact on the speculators and other gold purchasers.

Effects on the British Economy

9. Prices on the London stock exchange dropped sharply on Thursday, 23 November, and continued to decline on Friday, with the exception of gold mining shares, which increased. The initial reaction was to blame the devaluation and the run on gold. However, there had been a strong advance in London stock prices during the month of November and the drop on 23 and 24 November was due primarily to profit taking, triggered by Callaghan's statement that further retrenchment in the British economy probably would be necessary. As further evidence of the success of the Gold Pool in holding the line, on 27 November gold mining shares were generally weak in both London and Johannesburg compared with the previous week.

10. The British Government got a boost on Thursday, 23 November, when the General Council of the Trades Union Congress (TUC) gave full backing to a post-devaluation wage freeze. The TUC, like the government, plans to rely on voluntary cooperation for enforcement. With sizeable wage claims for several million workers already in the pipeline, this may prove difficult. The leaders of Britain's two largest trade unions have already said they will press for some major wage increases.

11. The initial reaction of the British business community to devaluation shows little enthusiasm for mounting the bold new export drive that is vital to the longer term success of the government's program. Established exporters will enjoy immediate price advantages, but the problems of quality and delivery that have plagued some British exports remain. For the longer run, industrialists stress that price advantage is only one element, and that other elements bearing on profit outlook, particularly wage prospects, the credit squeeze, and the tax structure, will have great weight. Another important element in this attitude is the business community's badly shaken confidence in the government.

Support Operations

12. With the exception of France, the industrial nations have undertaken three principal kinds of operations in support of the US dollar. First, all have pledged not to place additional strain on US gold stocks by refraining from any conversions of officially held dollars to gold. Furthermore, their agreement to act unanimously and in coordination carries with it a pledge of each nation's gold stocks to support operations in the London Gold Pool.

13. The second type of dollar support consists of agreements to permit a substantial increase in the so-called "swap" operations among the major central banks--from $3.15 billion to $6.55 billion. These "swaps" work as follows: when a country--the US, for example--finds its own currency being sold heavily for another in

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FOREIGN EXCHANGE RATE CHANGES SINCE THE STERLING DEVALUATION ON 18 NOVEMBER

Country	Currency	US Dollar Price Before 18 Nov 67	US Dollar Price After 18 Nov 67	Percent Devaluation	Date of Devaluation
Western Europe					
Cyprus	Pound	2.80	2.40	14.3	22 Nov
Denmark	Krone	0.14472	0.13333	7.9	19 Nov
Ireland	Pound	2.80	2.40	14.3	19 Nov
Malta	Pound	2.80	2.40	14.3	19 Nov
Spain	Peseta	0.016667	0.014286	14.3	19 Nov
Iceland	Krona	0.02326	0.01754	24.6	24 Nov
Africa					
Gambia	Pound	2.80	2.40 a/	14.3	19 Nov
Malawi	Pound	2.80	2.40 a/	14.3	19 Nov
Mauritius	Rupee	0.21	0.18 a/	14.3	19 Nov
Sierra Leone	Leone	1.40	1.20	14.3	21 Nov
Western Hemisphere					
Bahama Islands	Dollar	0.98	0.96	2.0	19 Nov
Bermuda	Pound	2.80	2.40 a/	14.3	19 Nov
Guyana	Dollar	0.5833	0.5000	14.3	20 Nov
Jamaica	Pound	2.80	2.40	14.3	20 Nov
Lesser Antilles	East Caribbean Dollar	0.5833	0.5000	14.3	20-21 Nov
Near East					
Israel	Pound	0.3333	0.2857	14.3	19 Nov
South Asia					
Ceylon	Rupee	0.210	0.168	20.0	21 Nov
Fiji Islands	Pound	2.54	2.18 a/	14.3	19 Nov
Hong Kong	Dollar	0.175	0.165	5.7 b/	19 & 23 Nov b/
New Zealand	Dollar	1.40	1.12	20.0	21 Nov

a/ *Amount of devaluation not announced. Exchange rate shown assumes a devaluation proportional to the 18 November sterling devaluation.*

b/ *Announced on 19 November as a 14.3 percent devaluation. Revalued by 10.0 percent on 23 November to 5.7 percent devaluation from the 18 November level.*

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the foreign exchange markets, it deposits some of its own currency with a foreign central bank in return for an equivalent deposit of the other currency which is in demand. This is in effect a loan of the scarce currency. If, in the example cited, the dollar began to weaken because of excessive sales of dollars, the US would then have a sufficient supply of the foreign currency to exchange for dollars. The swap agreements carry exchange rate guarantees, and they are normally "reversed"--i.e., liquidated by withdrawals of both deposits--after three months. The effect of these agreements to permit an increase in swap transactions is to give a country additional funds with which to counter speculative attacks on its currency in the foreign exchange markets.

14. The third type of support--now promised by West Germany, the Netherlands, and Belgium--consists of central banks conducting forward dollar operations with their own commercial banks. This technique works as follows: the central bank will sell spot dollars to commercial banks, at the same time signing a forward (usually three months) contract to repurchase the dollars for domestic currency. Moreover, it spreads the exchange rates of the spot sales and forward repurchases in such a manner as to offer the commercial banks a premium, thereby giving the banks an incentive to acquire dollars in this way and to invest them in New York, earning an additional interest return. The method works well, and it has the effect both of preventing a rapid accumulation of dollars in foreign central banks and of inducing a flow of dollar funds to the New York money market.

Devaluation of Other Currencies

15. The devaluation of sterling on 18 November has been followed by the devaluation of a number of lesser countries. By 27 November, 20 minor currencies had been devalued and others probably will join the list (see chart). The major industrial countries have indicated their intention not to devalue.

16. At least six countries devalued for reasons beyond the importance of their trade with Britain:

a. <u>Denmark</u> has had a persistent balance-of-payments deficit stemming from large trade deficits as well as from considerable domestic inflation. A fourth of its exports are marketed in Britain.

b. <u>Israel</u> has had chronic trade deficits. Although the Israeli pound long has been overvalued, earlier devaluation would have risked serious domestic political repercussions. Sterling devaluation provided a suitable occasion.

c. <u>Spain</u> has been plagued with domestic inflation and a deteriorating balance of payments.

d. <u>Iceland</u> has been running a substantial balance-of-payments deficit. The fishing industry, which accounts for about 90 percent of total exports, has been hit hard by foreign competition in its principal export markets.

e. <u>Ceylon</u> has had balance-of payments deficits since 1960. Balance of trade with Britain, its largest trading partner, has been favorable.

f. <u>New Zealand</u> has had persistent deficits in its foreign trade and balance of payments. The new exchange rate places the New Zealand dollar on a par with the Australian dollar.

17. Hong Kong and Ireland are the only other large traders that have devalued. Their decisions to devalue their currencies, though the extent differs, were dictated by intricate commercial and financial ties with Britain. The remaining currencies devalued thus far serve backwater areas of the British Commonwealth that have little impact on world trade. Most of these were encouraged by the British to devalue, probably to dampen increases in prices of British imports from them.

Domestic Political Developments in the UK

18. Prime Minister Wilson had little trouble holding the Labor Party in line during last week's parliamentary debate on devaluation. At the same time the prime minister's personal credibility with both the Laborite MPs and the public fell further under the weight of Wilson's too coldly calculated defenses of his government's past performance and present program. In contrast, Chancellor of the Exchequer Callaghan's standing rose because of his humble admissions of failure. He appears to have improved his position to the point where Wilson will have to keep him on in a key portfolio after any future cabinet reshuffle.

19. The Conservatives for their part have been handicapped in exploiting the situation by their failure to present credible and practical economic alternatives. The Tories did win an impressive parliamentary by-election victory a few days after devaluation, but the real humiliation for Labor was the fact that they fell to third behind the Liberals in that poll.

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